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Pending Protocol Will Prevent Inverted Corporations from Accessing the Barbados Treaty

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INTRODUCTION

Barbados has become a desirable destination for U.S. companies that engage in "inversion transactions." In part, this is because many companies nominally resident in Barbados pay little tax. A corporation to which the International Business Companies Act applies (an "IBC"), for example, pays Barbados tax at a maximum rate of 2.5% which is gradually reduced to 1% as income increases.[1] Such a lightly taxed entity may nevertheless qualify for the benefits of the U.S. Barbados Income Tax Treaty, signed December 31, 1984 (the "Treaty"), if it is a resident of Barbados and satisfies the Treaty's limitation on benefits ("LOB") article.[2]

On July 14, 2004, the United States and Barbados signed a new protocol (the "Pending Protocol") that will make it virtually impossible for inverted U.S. companies to access the Treaty.[3] Among other modifications, the tougher LOB article will make it extremely difficult to satisfy the public company test and the ownership/base erosion test. Moreover, a company that otherwise satisfies the tougher LOB requirements will nevertheless be disqualified from accessing certain articles of the Treaty if it enjoys the benefits of a "special tax regime".

Before describing in detail the Pending Protocol's "new and improved" LOB provision, a brief review of the pertinent provisions of the current treaty is in order.

THE CURRENT TREATY

Requirements for Treaty Benefits

In order for a foreign corporation to claim the benefits of the Treaty, it must (1) qualify as a resident of Barbados and (2) satisfy the requirements of the LOB article.[4]

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1 See Office of Tax Policy Department of the Treasury, "Corporate Tax Inversion Transactions: Tax Policy Implications" (May 2002) at n.27.

2 The Treaty was amended by a Protocol signed on December 18, 1991 (the "1991 Protocol"). The 1991 Protocol deleted and replaced the original treaty's LOB article.

3 The discussion below assumes that the Pending Protocol will be ratified in its current form. Obviously, there can be no assurance that this will in fact be the case.

4 Limitations outside the Treaty may also apply in certain circumstances, such as the principles of substance over form and special provisions of the Code and regulations dealing with conduit financing arrangements and

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Article 4.1(a)(ii) of the Treaty provides that the term "resident of Barbados" includes "a company whose business is managed and controlled in Barbados." This provision differs somewhat from the typical "liable to tax" test found in most U.S. income tax treaties,[5] but the difference does not appear to be substantive, since a corporation that is managed and controlled in Barbados is liable to Barbados tax as a Barbados resident, even if at reduced rates pursuant to the IBC regime. Notably, a corporation need not be formed in Barbados to qualify as a Barbados resident under the Treaty. For example, a corporation incorporated in Bermuda may qualify as a Barbados resident under the Treaty if it is managed and controlled in Barbados. For purposes of the discussion below, any corporation that is considered a resident of Barbados due to such management and control will be referred to as a "Barbados corporation" (or Barbados company) regardless of where it is organized.

Pursuant to Article 22.1(d) of the Treaty (as currently in effect), a person that is a resident of either Barbados or the United States is entitled to all of the benefits of the Treaty if such person is "a company in whose principal class of shares there is substantial and regular trading on a recognized stock exchange[.]" For this purpose, a recognized stock exchange includes (a) the NASDAQ and any stock exchange registered with the SEC as a national securities exchange under the Securities Exchange Act of 1934, and (b) any other stock exchange agreed upon by the competent authorities.[6]

When combined with the favorable IBC regime, these treaty provisions have made Barbados a highly desirable destination for U.S. public companies that engage in "inversion transactions", described below.

Inversion Transactions

More Favorable Treatment of Foreign Owned Multinationals

A domestic corporation is subject to U.S. federal income tax on its worldwide income. Moreover, pursuant to Subpart F of the Code, a domestic corporation is subject to current tax on its proportionate share of any "Subpart F income" earned by its "controlled foreign corporation" ("CFC") subsidiaries.[7] Subpart F income includes most passive income, such as most interest and dividends, as well as certain active income from transactions involving related parties.[8]

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payments to hybrid entities. See, e.g., Del Commercial Properties, Inc. v. Commissioner, 251 F.3d 210 (DC Cir. 2001); §§894(c) and 7701(l); Reg. §§1.881-3 and 1.894-1(d). Except as otherwise expressly indicated, all "Section" and "§" references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), and the regulations thereunder.

5 Under Art. 4.1 of the United States Model Income Tax Convention of September 20, 1996 (the "1996 U.S. Model Treaty"), for example, the term "resident of a Contracting State" generally means "any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature."

6 1984 U.S.-Barbados Income Tax Treaty, Art. 22.3.

7 §951(a)(1)(A)(i). A foreign corporation is a CFC if "United States shareholders" own (directly, indirectly or through application of certain "attribution" rules) a majority of the shares (measured by either vote or value) of the foreign corporation. §957(a). For this purpose, a United States shareholder is any U.S. person who owns (directly, indirectly or through application of certain "attribution" rules) shares possessing 10 percent or more of (continued)

Even if income earned by a domestic corporation through a CFC is non-Subpart F income eligible for deferral, such income ultimately is taxed when the domestic parent corporation receives a dividend from the CFC.[9] Furthermore, if the CFC makes certain impermissible investments in "United States property", the U.S. parent corporation generally will be taxed in the same manner as if it had received a dividend from the CFC.[10]

Foreign tax credits reduce the potential for double taxation,[11] but complex limitations apply. The basic limitation is set forth in Section 904(a), which provides that the allowable foreign tax credit cannot exceed the product of (1) the taxpayer's tax liability determined without regard to foreign tax credits (the "tentative tax liability") and (2) a fraction the numerator of which is the taxpayer's foreign-source taxable income for the taxable year and the denominator of which is the taxpayer's total taxable income for the taxable year. Pursuant to Section 904(d), this limitation is applied separately to various categories of income commonly referred to as "baskets".

The Section 904(a) limitation, as applied to each "basket" of income set forth in Section 904(d), may take on increased significance if an item of income is subject to foreign tax (*e.g.*, because it is considered to have a foreign source) but has a U.S. source under the Code. In most circumstances, the result is simply that no foreign tax credit is allowed because the taxpayer is not considered to have earned any foreign-source income. For this purpose, the source of the income item under foreign law is irrelevant.[12]

Various additional limitations also apply. For example, a domestic corporation that is subject to the alternative minimum tax (AMT) generally may not use foreign tax credits to offset more than 90 percent of its AMT tax liability (determined without regard to foreign tax credits).[13]

Moreover, even if the impact of the foregoing limitations can be avoided, "residual" U.S. tax may still be imposed. For example, if a domestic corporation in the 35 percent tax bracket earns income of $100x and pays $20x of creditable foreign income tax, this amount will be

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the total voting power of the foreign corporation. §951(b).

8 §§952(a) and 954.

9 Indeed, if the CFC that earns the non-Subpart F income is a lower-tier CFC, the domestic parent corporation may be subject to current tax when the lower-tier CFC pays a dividend to an upper-tier CFC, since, as noted above, dividends generally constitute Subpart F income. See §§952(a), 954(a) (1) and 954(c)(1)(A). Pursuant to a "same country exception", however, dividends (or interest) received from a related CFC are not considered Subpart F income if both CFCs are created or organized under the laws of the same foreign country and certain other requirements are satisfied.

10 §956. For this purpose, debt of the CFC's United States shareholder is considered United States property. In the absence of such a rule, it might be desirable for a CFC to loan funds to its United States shareholder to avoid the U.S. tax consequences of paying a dividend.

11 See generally §§901 and 902. The potential for double taxation arises if the earnings of the foreign subsidiaries are subject to foreign tax or if distributions by the foreign subsidiaries are subject to foreign withholding tax.

12 In certain circumstances, gains from the sale of stock or intangible property may be recharacterized as foreign-source under an applicable U.S. tax treaty. See §865(h). This is the exception, however, rather than the rule.

13 §59(a)(2)(A).

credited against the "tentative" U.S. tax of $35x so that an additional $15x of U.S. federal income tax will still be owed.[14] This $15x is referred to as the "residual" U.S. tax.

In contrast, the U.S. tax rules for multinational groups with a foreign parent are far more favorable. First and foremost, the offshore activities of the foreign parent and its foreign subsidiaries generally escape U.S. corporate tax entirely.[15] Subpart F, for example, does not apply, provided that the foreign corporations are not CFCs. It is possible, but unlikely, that a publicly held corporation or its foreign subsidiary would be a CFC.[16] Moreover, although the U.S. subsidiaries are still subject to U.S. tax, it may be possible to reduce their taxable income through deductible interest or royalty payments to foreign affiliates.[17] If the foreign affiliates qualify for the benefits of a U.S. tax treaty, this structure will be particularly desirable from a U.S. tax perspective, because the U.S. withholding tax on such payments will be imposed at a reduced rate if not eliminated entirely.[18] To the extent that the U.S. subsidiaries have some remaining profit, the rate of U.S. withholding tax on dividends paid to the foreign parent corporation will also qualify for a reduced rate of (or possibly a complete exemption from) U.S. withholding tax.[19]

For these reasons, the U.S. tax treatment of foreign based multinational groups clearly is more favorable than that of U.S. based groups. Accordingly, new ventures that contemplate substantial business activities outside the U.S. have a powerful tax incentive to locate the parent corporation outside the U.S. Similarly, not-so-new ventures with substantial offshore activities have an incentive to invert.

Inversion Transactions Used to Obtain More Favorable Treatment

A number of U.S. public companies have engaged in inversion transactions to reinvent themselves as foreign-based multinationals. Inversion transactions may be effected in various ways, but in each case the result is that the public shareholders receive shares of a new foreign corporation in exchange for their shares of the former U.S. parent.[20] In the case of an inversion

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14 For purposes of this example, assume that all of the income falls within the same basket for purposes of §904(d).

15 As the amount of creditable foreign tax imposed with respect to any "basket" of income increases, however, the benefit of avoiding U.S. corporate tax is reduced, since a greater portion of the tentative U.S. tax liability generally would have been offset by foreign tax credits. But, as indicated above, a number of limitations may prevent a domestic corporation from using foreign tax credits to fully offset its tentative U.S. tax liability. See, e.g., §59(a)(2)(A).

16 As noted above, a foreign corporation is a CFC if a majority of its shares (measured by either vote or value) is owned (directly, indirectly or though certain "attribution" rules) by United States shareholders; but for this purpose only U.S. persons who own (directly, indirectly or though certain "attribution" rules) shares possessing 10 percent of the voting power of the foreign corporation qualify as United States shareholders.

17 Note that, in addition to other limitations, any such deductible expenses would be subject to scrutiny and potential reallocation under §482.

18 In such cases, the "earnings stripping" rules of §163(j) limit the amount of deductible interest that may be paid to an affiliate that is not subject to U.S. withholding tax, but a significant amount of "earnings stripping" is still permitted.

19 As of the date of this writing, only a few U.S. income tax treaties provide for a complete exemption from U.S. withholding tax on dividends.

20 For a description of various inversion techniques, see, e.g., Office of Tax Policy Department of the Treasury,

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that is a “stock transaction,”[21] such exchange may satisfy the general requirements for treatment as a tax-free reorganization under §368, but the shareholders will nevertheless be subject to tax on the exchange pursuant to §367(a).[22] If a shareholder is tax-exempt (or the company's shares are trading poorly), such theoretically taxable transaction may not actually result in increased tax. Reporting requirements may apply, but it is not likely that these would be viewed as a bar to an otherwise desirable inversion.[23]

The basic inversion transaction sets the stage for keeping the earnings of the new foreign parent corporation and its foreign subsidiaries offshore, but, if any member of the U.S. group continues to own foreign subsidiaries, those foreign subsidiaries will continue to be CFCs and their earnings will continue to be subject to Subpart F.[24] Therefore, it may also be desirable to “de-control” any remaining CFCs by transferring the stock of such foreign corporations to the new foreign parent in a taxable sale.[25] Depending on the U.S. holding company's adjusted tax basis in the CFC shares (and the foreign tax credits generated) the tax bill from the sale may not be substantial.[26]

These transactions successfully remove the group's offshore earnings from Subpart F, and the U.S. tax system generally,[27] but the earnings of the U.S. group continue to be subject to U.S. corporate tax. The group's U.S. tax base can be reduced through the payment of deductible interest or (if intangibles are moved or created offshore) royalties to the new foreign parent or another foreign affiliate located in a tax-haven jurisdiction, but in the absence of an applicable U.S. tax treaty, such payments will be subject to U.S. withholding tax at the statutory rate of 30%.[28] This is not a bad result, but clearly there is room for improvement.

“Corporate Tax Inversion Transactions: Tax Policy Implications” (May 2002); Tello, “The Upside Down World of Corporate Inversion Transactions,” Tax Management International Journal 161 (2001).

21 For purposes of this discussion, an inversion will be considered a “stock transaction” if the structure of the former U.S. corporate group remains basically unchanged except that the stock of the former U.S. parent is owned by the new foreign parent.

22 See Reg. §1.367(a)-3(c). In the case of an inversion involving a transfer of assets to the new foreign parent, such outbound asset transfer would be taxable to the U.S. transferor, pursuant to §367(a)(5), even if the transaction otherwise qualifies as a tax-free reorganization under §368.

23 See Temp. Reg. §1.6043-4T and, in particular, Temp. Reg. §1.6043-4T(h), Ex. 1.

24 Note also that, even to the extent that the CFCs' earnings constitute non-Subpart F income eligible for deferral, such earnings would be subject to U.S. corporate tax when ultimately repatriated to the corporate U.S. shareholder.

25 For example, such CFC shares may be exchanged for nonvoting shares of the new foreign parent. This was done, for example, in the inversion consummated by Ingersoll-Rand Company. See the prospectus filed with the SEC on November 2, 2001.

26 Pursuant to §1248, all or a portion of the gain recognized upon a taxable disposition of CFC shares may be recharacterized as a dividend, and dividends from CFCs carry indirect foreign tax credits pursuant to §902.

27 Any U.S. persons who own shares of the foreign parent, however, will be taxed on all dividends received from the foreign parent. Furthermore, such U.S. persons will be subject to certain anti-deferral rules if the foreign parent is a passive foreign investment company. See §§1291-1298.

28 Although U.S. withholding tax is not imposed on portfolio interest, interest paid to a “10-percent shareholder” cannot qualify as portfolio interest. §§871(h)(3) and 881(c)(3)(B). Attribution rules apply for purposes of determining 10-percent shareholder status, and thus an affiliated foreign lender would be considered a 10-percent shareholder of the U.S. debtor.

In the last few years, a new wrinkle has been added that may permit the earnings of the U.S. group to be stripped out without imposition of the full U.S. withholding tax.[29] Under this "new and improved" inversion transaction, the foreign parent is still formed in a tax-haven jurisdiction, such as Bermuda, but management activities (or at least a few Board meetings) are moved to Barbados and a substantial reduction in U.S. withholding tax is claimed under the Treaty.

As discussed above, a corporation that is managed and controlled in Barbados will be considered a resident of Barbados for purposes of the Treaty, even if it is organized outside Barbados, *e.g.*, in Bermuda. If there is substantial and regular trading of the corporation's principal class of shares on a recognized stock exchange, then the corporation is eligible for the benefits of the Treaty.

Accordingly, The Stanley Works proposed in 2002 to consummate an inversion pursuant to which a new parent ("Stanley Bermuda") would be organized in Bermuda, but would be managed and controlled in Barbados, in order to qualify as a Barbados resident and thereby access the Treaty. The prospectus filed with the SEC on June 21, 2002,[30] explained as follows:

> "Stanley Bermuda believes that it will be managed and controlled in Barbados because its Board of Directors has agreed that at least three quarters of its meetings will physically take place in Barbados and that most of the Stanley Bermuda strategic decisions will be made by the Board at meetings physically held in Barbados. Assuming Stanley Bermuda qualifies as a Barbados resident, it will be entitled to certain benefits under the United States-Barbados Income Tax Treaty. These benefits include the reduction (from 30% to 5%) of the U.S. withholding tax on dividend distributions paid from Stanley US Holdings, Inc. to Stanley Bermuda. If the benefits of the United States-Barbados Income Tax Treaty were not available because, for example, Stanley Bermuda was deemed to be a tax resident of Bermuda, the United States would impose a withholding tax at a rate of thirty percent (30%) on those distributions."

Thus, the Treaty would reduce the U.S. withholding tax on dividends paid by the U.S. holding company to the Bermuda/Barbados parent to 5%.[31] The U.S. withholding tax on interest and royalty payments would also qualify for a 5% withholding rate.[32] Not bad, considering that Bermuda has no corporate income tax and that the Barbados tax rate for IBCs ranges from a

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29 See Tello, "Inversion Transactions: New Style Transactions Raise New Policy Issues," 43 Tax Mgmt. Memo. 211 (June 3, 2002). See also Office of Tax Policy Department of the Treasury, "Corporate Inversion Transactions: Tax Policy Implications" (May 2002).

30 The shareholders initially approved the proposed inversion at the annual meeting held on May 9, 2002, but due to a number of concerns raised about the vote, the company circulated a new prospectus on June 21, 2002 announcing a special meeting to reconsider the issue. Following the public uproar and threats of adverse legislation, The Stanley Works ultimately withdrew its inversion plan.

31 1984 U.S.-Barbados Income Tax Treaty, Art. 10.2(a).

32 1984 U.S.-Barbados Income Tax Treaty, Arts. 11.1 and 12.2.

maximum of 2.5% to as low as 1%, depending on the amount of income earned. It is not difficult to see how the U.S. would consider this state of affairs to be objectionable.[33]

A number of solutions to the inversion "problem" have been proposed. Under one proposal, for example, the new foreign parent of an inverted U.S. corporation would be treated as a domestic corporation.[34] Under another proposal, the taxable income of an "expatriated entity" for any year during the period ending 10 years after completion of the expatriation transaction could in no event be less than the entity's "inversion gain" for that year.[35] It has also been proposed that stock options and other stock-based compensation held by certain executives of an inverted corporation would be subject to an excise tax.[36] Yet another proposal spurred by inversion concerns is to significantly tighten the earnings stripping rules of Section 163(j).[37] No consensus has been reached, perhaps due in part to the lack of a widely held conviction that inversions, by themselves, are terribly inappropriate.

The Pending Protocol does not attempt to deal with inversion transactions in a comprehensive way, but clearly was intended to prevent inverted public companies from accessing the Treaty. Mission accomplished.

THE PENDING PROTOCOL

The Pending Protocol will replace Article 22 (Limitation on Benefits) of the Treaty with a new LOB article. The new LOB article contains several unusual provisions that make it virtually impossible for an inverted public company to access the treaty.

As discussed below, the changes made in the new LOB article include a tougher public company test, a tougher ownership/base erosion test and a narrow definition of bank for purposes of the active business test. In the unlikely event that an inverted public company can satisfy any of these tests, the most significant benefits of the Treaty would still be denied if the company is subject to a special tax regime. For convenience, any U.S. or Barbados resident that is denied such Treaty benefits on account of enjoying the benefits of a special tax regime is referred to herein as a "Disqualified Resident".

Higher Hurdle to Satisfy The Public Company Test

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33 In addition to the tax policy issues raised by this result, query whether a few Board meetings in Barbados truly are sufficient to constitute management and control in any meaningful sense. Apparently, The Stanley Works did not really think so, since the prospectus filed with the SEC on June 21, 2002 states that "It is our goal to keep our management in the U.S. and our headquarters in New Britain, Connecticut." Nevertheless, if Barbados treats a company as a resident on the ground that it is managed and controlled in Barbados, the U.S. would not seem to be in a position to disagree.

34 See, e.g., H.R. 1531, §401; S. 1149, §821.

35 See, e.g., H.R. 2896, §2002.

36 See, e.g., H.R. 2896, §2003, S. 1149, §803. In addition to deterring inversion transactions generally, the excise tax proposal apparently is motivated by the view that the executives who hold stock options, and who generally are instrumental in deciding to engage in inversion transactions, should not be treated more favorably than the shareholders who typically must recognize gain in connection with such transactions. See S. Rep't 108-54 to S. 1149 (May 23, 2003).

37 See, e.g., The President's Budget for the United States Government, Fiscal Year 2004

As noted above, a resident of Barbados is entitled to all of the benefits of the Treaty (as currently written) if it is "a company in whose principal class of shares there is substantial and regular trading on a recognized stock exchange[.]"[38] For this purpose, a recognized stock exchange includes NASDAQ and any stock exchange registered with the SEC as a national securities exchange under the Securities Exchange Act of 1934.[39] Thus, for example, a corporation that is a resident of Barbados may satisfy this "public company test" if there is substantial and regular trading of its principal class of shares on the New York Stock Exchange.

New Article 22.1(c)(i) of the Treaty will tighten the public company test by requiring that the principal class of shares of the company be:

> "(a) listed on a recognized stock exchange located in the Contracting State of which the company is a resident;
>
> (b) primarily traded on a recognized stock exchange located in the Contracting State of which the company is a resident or, in the case of a company that is resident in Barbados, primarily traded on one of the recognized stock exchanges identified in paragraph 4(b) of Article 22; and
>
> (c) regularly traded on one or more recognized stock exchanges[.]"[40]

New Article 22.4 of the Treaty will define the term "recognized stock exchange as follows:

> "4. For the purposes of paragraph 1, the term 'recognized stock exchange' means:
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> (a) the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934;
>
> (b) the Barbados Stock Exchange, the Jamaica Stock Exchange and the Trinidad Stock Exchange; and
>
> (c) any other stock exchange agreed upon by the competent authorities of the Contracting States."

Under these new rules, a company that is a resident of Barbados will satisfy the public company test only if its principal class of shares is (1) listed on a recognized stock exchange in Barbados, (2) primarily traded on the Barbados Stock Exchange, the Jamaica Stock Exchange or

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38 1984 U.S.-Barbados Income Tax Treaty, Art. 22.1(d).
39 1984 U.S.-Barbados Income Tax Treaty, Art. 22.3(a).
40 1984 U.S.-Barbados Income Tax Treaty, as proposed to be modified by the Pending Protocol, Art. 22.1(c)(i).

the Trinidad Stock Exchange, and (3) regularly traded on one or more recognized stock exchanges, wherever located.

The second requirement is the most problematic. As stated above, the Barbados company's principal class of shares must be “primarily traded” on the Barbados Stock Exchange, the Jamaica Stock Exchange or the Trinidad Stock Exchange.

The Pending Protocol does not define the term “primarily traded”. The same term is used in the public trading test of the branch profits tax,[41] however, and the regulations issued under §884 provide as follows:

> “(3) Primarily traded. For purposes of this section, stock of a corporation is 'primarily traded' on one or more established securities markets in the corporation's country of residence or in the United States in any taxable year if, with respect to each class described in paragraph (d)(4)(i)(A) of this section (relating to classes of stock relied on to meet the regularly traded test) --
>
> (i) The number of shares in each such class that are traded during the taxable year on all established securities markets in the corporation's country of residence or in the United States during the taxable year exceeds
>
> (ii) The number of shares in each such class that are traded during that year on established securities markets in any other single foreign country.”[42]

Therefore, it appears that the primarily traded requirement can only be satisfied if more shares are traded on the Barbados Stock Exchange, the Trinidad Stock Exchange or the Jamaica Stock Exchange than on any other exchange. It seems unlikely that inverted public companies will consider this to be a viable option.

The Pending Protocol's “primarily traded” requirement is unusually strict. Under most U.S. income tax treaties in force today, and under the 1996 U.S. Model Treaty, the requirements for the publicly traded test can be fully satisfied through trading on a recognized stock exchange in <u>either</u> Contracting State.[43]

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41 Pursuant to §884(e), a foreign corporation generally may obtain an exemption from (or reduction of) the branch profits tax pursuant to a U.S. tax treaty with a foreign country only if the foreign corporation is a “qualified resident” of that foreign country. Pursuant to §884(e)(4)(B), a foreign corporation that is a resident of a foreign country will be considered a “qualified resident” of that foreign country only if its stock is “primarily and regularly traded on an established securities market in such foreign country[.]” A similar term is used in §883(c), which acts as an LOB provision for foreign corporations attempting to access the reciprocal exemption available under §883(a) for certain income derived from the international operation of ships or aircraft. Pursuant to §883(c)(3)(A), a foreign corporation may satisfy the LOB requirements of §883(c) if, among other requirements, its shares are “primarily and regularly traded on an established securities market[.]”

42 Reg. §1.884-5(d)(3).

43 For exceptions, see U.S.-Kazakhstan Income Tax Treaty, signed October 24, 1993, Art. 21.1(c); U.S.-Russian Federation Income Tax Treaty, signed June 17, 1992, Art. 20.1(c); U.S.-Ukraine Income Tax Treaty, signed

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The Pending Protocol's imposition of a stricter public trading test obviously was motivated by concerns specific to Barbados as a destination for inverted corporations, but may also reflect an increasing reexamination of the long-held assumption that public companies are above treaty shopping. A pending protocol to the U.S.-Netherlands Income Tax Treaty, signed December 18, 1992, reflects similar concerns but takes a different approach by providing that the public company test can only be satisfied by a company that has a "substantial presence" in its state of residence.[44]

Not surprisingly, the strict public trading test introduced by the Pending Protocol cannot be avoided by attempting to qualify a subsidiary, rather than the publicly held company itself, under the Treaty. Indeed, attempting to use a subsidiary to access the Treaty only makes the task more difficult.

Pursuant to new Article 22.1(c)(ii) of the Treaty, a company that is a resident of a Contracting State will satisfy the "public company subsidiary test" if:

- at least 50 percent of each class of shares is owned, directly or directly, by companies that satisfy the public company test described above,

- any intermediate owner in the chain is also a person entitled to the benefits of the Treaty under the public company subsidiary test, and

- the company satisfies the unusually rigorous base erosion test described below.

Therefore, if a publicly held Barbados company does not satisfy the public company test, *e.g.*, because it is primarily traded on the wrong stock exchange, its subsidiary will similarly fail the public company subsidiary test.

In the unlikely event that a Barbados company actually satisfies the public company test, the base erosion test will impose an additional hurdle on any attempt to qualify a Barbados subsidiary under the public company subsidiary test. As discussed below, the base erosion test will not be satisfied if a resident of Barbados erodes 50 percent or more of its tax base for Barbados income tax purposes through certain deductible payments to (1) persons who are not residents of Barbados or (2) persons who are residents of Barbados but who (a) are not entitled to the benefits of the Treaty under certain specified provisions of the LOB article or (b) are Disqualified Residents.

Thus, for example, a Barbados finance subsidiary of a Barbados company that satisfies the public company test could not erode 50 percent or more of its Barbados tax base through deductible payments to an affiliated Barbados company that enjoys the benefits of a special tax

March 4, 1994, Art. 22.1(c).

44 1992 U.S.-Netherlands Income Tax Treaty, as proposed to be modified by the protocol signed March 8, 2004, Art. 26.2(c)(i).

regime. A Barbados finance subsidiary similarly could not erode 50 percent or more of its Barbados tax base by making such payments to a U.S. affiliate.

It is unusual in U.S. tax treaties for a base erosion requirement to be imposed under the public company subsidiary test;[45] and, as discussed below, no other U.S. tax treaty treats payments by a resident of one Contracting State to residents of the other Contracting State as base eroding payments. Clearly, the U.S. treaty negotiators did not intend to take any chances with inverted companies and their subsidiaries.

More Restrictive Ownership/Base Erosion Test

The Pending Protocol will also modify the Treaty's ownership/base erosion test to impose a "same country" ownership requirement.

Article 22.1(e) of the Treaty currently provides that a resident of a Contracting State will be entitled to all of the benefits of the Treaty if such person is:

> "(i) a person, more than 50 percent of the beneficial interest in which (or in the case of a company, more than 50 percent of the number of shares of each class of whose shares) is owned, directly or indirectly, by persons entitled to the benefits of this Convention under subparagraphs (a), (b), (d), or (f) or who are citizens of the United States; and
>
> (ii) a person, more than 50 percent of the gross income of which is not used, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons not entitled to the benefits of this Convention under subparagraphs (a), (b), (d), or (f) and who are not citizens of the United States[.]"

Under this fairly typical provision, a company may satisfy the ownership prong if more than 50 percent of each class of shares is owned by qualifying residents of <u>either</u> Contracting State.[46] Thus, for example, qualifying owners of a Barbados company include U.S. citizens. An inverted company might easily satisfy this ownership requirement. Assuming that the base erosion test is also satisfied, the inverted company would still be able to access the Treaty, notwithstanding its rather tenuous connection to Barbados.

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45 For an exception, see U.S.-Luxembourg Income Tax Treaty, signed April 3, 1996, Art. 24.2(e). Note also that many U.S. income tax treaties do not contain a public company subsidiary test. Absent such a provision, a public company subsidiary generally would need to satisfy the ownership/base erosion test.

46 Under the typical ownership/base erosion test, the requisite interest (in this case, ownership of more than 50 percent of each class of shares) must be owned, directly or indirectly, by persons who qualify for the benefits of the treaty under certain specified provisions of the LOB article (in this case, subparagraphs (a), (b), (d) or (f) of Article 22.1 of the Treaty). For convenience, a resident of a Contracting State who satisfies such additional requirements, and therefore counts towards satisfaction of the ownership requirement, is referred to herein as a "qualifying resident". This term does not appear in the Treaty or the Pending Protocol.

The Pending Protocol will prevent this result by modifying the ownership/base ownership test to impose a "same country" requirement. Under new Article 22.1(d)(i) of the Treaty, a resident of a Contracting State will satisfy the ownership prong of the test only if:

> "i) on at least half the days of the taxable year, more than 50 percent of the beneficial interest n that person (or in the case of a company, more than 50 percent of the number of shares of each class of shares) is owned, directly or indirectly, by residents of that State that are entitled to the benefits of this Convention under subparagraphs (a), (b), (c)i), (e) or (f) (other than a person described in paragraph 6 of this Article), provided that, in the case of indirect ownership, each intermediate owner is a resident of that Contracting State[.]"

Thus, in order for a Barbados company to satisfy the modified ownership requirement, a majority of each class of shares will need to be owned, directly or indirectly, on at least half of the days of the taxable year, by qualifying residents of *Barbados*. U.S. ownership will *not* suffice.

This is an unusual provision. Under most U.S. income tax treaties, and under the 1996 U.S. Model Treaty, ownership by qualifying residents of either Contracting State is "good" ownership for purposes of the ownership prong of the ownership/base erosion test.[47]

The Pending Protocol also modifies the base erosion prong of the ownership/base erosion test. Under the existing LOB provision, only payments to persons who are not qualified residents of either the U.S. or Barbados (and who are not U.S. citizens) are considered base eroding payments.

Under new Article 22.1(d)(ii) of the Treaty, a resident of a Contracting State will satisfy the base erosion prong of the ownership/base erosion test only if:

> "ii) less than 50 percent of the person's gross income for that taxable year is paid or accrued, directly or indirectly, to persons who are not residents of that Contracting State entitled to the benefits of this Convention under subparagraphs (a), (b), (c)i), (e) or (f) (other than a person described in paragraph 6 of this Article) in the form of payments that are deductible for the purposes of the taxes covered by this Convention in the State of which the person is a resident (but not including arm's length payments in the ordinary course of business for services or tangible property[.]"

Thus, a Barbados resident will fail the base erosion prong if it erodes its Barbados tax base through certain deductible payments to (1) persons who are not residents of Barbados or (2)

[47] For exceptions, see U.S.-Jamaica Income Tax Treaty, signed May 21, 1980, as modified by a protocol signed July 17, 1981, Art. 17.1(a); U.S.-Cyprus Income Tax Treaty, signed March 19, 1984, Art. 26.1(a).

persons who are residents of Barbados but who (a) are not entitled to the benefits of the Treaty under certain specified provisions of the LOB article or (b) are Disqualified Residents.

Under this unusually restrictive base erosion test, payments by a resident of one Contracting State to residents of the other Contracting State are treated in the same manner as payments to persons are not a resident of either Contracting State, *i.e.*, as base eroding payments. Thus, for example, a Barbados company will not satisfy the base erosion test of new Article 22.1(d)(ii) if it strips out 50% or more of its income through deductible payments to U.S. persons. No other U.S. income tax treaty imposes such a strict base erosion limitation.

In most cases, it seems unlikely that payments by a Barbados resident to a U.S. resident could be abusive, since the United States is not a tax haven, but there may be specific circumstances in which the U.S. payee would not be taxed on the base eroding payment.

One circumstance in which this may happen is where the transaction or instrument pursuant to which the payment is made is characterized or taxed differently for U.S. and Barbados tax purposes. For example, putative interest payments by a Barbados company to a U.S. investor may erode the Barbados tax base if the investment is respected as a loan for Barbados tax purposes, but would not trigger U.S. tax if, for U.S. tax purposes, the investment is characterized as equity and the payments constitute a tax-free return of capital under Section 301(c)(2).[48] Alternatively, a Barbados company may be entitled to a compensation deduction for Barbados tax purposes in connection with the issuance of stock options to, or the exercise of incentive stock options by, U.S. executives, even though such issuance and exercise would ordinarily be tax-free to the executives in the U.S.[49]

Even in the absence of any inconsistency in U.S. and Barbados tax treatment, the U.S. payee may not be subject to U.S. tax on the amount received. For example, the U.S. payee may be a tax-exempt organization or may have sufficient net operating losses or other tax attributes to offset all or substantially all U.S. tax liability arising from the receipt. The U.S. negotiators of the Pending Protocol justifiably concluded that the presence of a U.S. payee would not in all circumstances foreclose abuse.

In the event that a Barbados company fails the base erosion prong on account of deductible payments to a U.S. person that actually pays full U.S. tax on such receipts, the U.S. competent authority might well grant relief under the discretionary benefits provision of the LOB article.[50]

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[48] Note that, in accordance with Notice 94-47, 1994-1 C.B. 357, an instrument with substantial debt characteristics, which may therefore be respected as indebtedness for foreign tax purposes, can likely be structured to qualify as equity for U.S. income tax purposes.

[49] See §421(a); Reg. §1.83-3(a)(2). Note, however, that a different U.S. tax result may arise if a so-called option is deep in the money since it may then not be respected as an option for U.S. tax purposes. E.g., Rev. Rul. 82-150, 1982-2 C.B. 110. Note, the author has not undertaken to research Barbados tax law on this (or any other) issue.

[50] 1984 U.S.-Barbados Income Tax Treaty, as proposed to be modified by the Pending Protocol, Art. 22.3.

Active Business Test -- Narrow Definition of Bank

Under the “active business test” of the current LOB article, a resident of a Contracting State is entitled to treaty benefits with respect to income derived from the other Contracting State if such resident is:

> “(c) engaged in the active conduct of a trade or business in the first-mentioned Contracting State (other than the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company), and the income derived from the other Contracting State is derived in connection with, or is incidental to, that trade or business[.]”[51]

Conceivably, a Barbados holding company might claim the benefits of the Treaty on the ground that it is a bank and is engaged in the business of managing investments, *e.g.*, making loans to and holding shares of the members of the U.S. group. In this regard, an aggressive tax planner might rely on *The Limited*[52] in support of a broad interpretation of what it means to be a bank carrying on a banking business.[53]

Anticipating that an inverted company unable to satisfy the new public company test or the new ownership/base erosion test may flee to the active business test, the Pending Protocol cuts of the escape route by ensuring that only a “real” bank with a nexus to the Contracting State of residence will be able to qualify under the active business test.

The basic active business test to be set forth in new Article 22.2(a) is similar to the existing test described above:

> “A resident of one of the Contracting States will be entitled to the benefits of the Convention with respect to an item of income derived from the other State, regardless of whether the resident is entitled to benefits under paragraph 1, if the resident is engaged in the active conduct of a trade or business in the first-mentioned State (other than the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company), and the income derived from the other Contracting State is derived in connection with, or is incidental to, that trade or business and that resident satisfies any other conditions for obtaining such benefits.”

For this purpose, new Article 22.2(d)(i) provides that “a resident of a Contracting State will be treated as a bank only if:

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51 1984 U.S.-Barbados Income Tax Treaty, Art. 22.1(c).

52 The Limited, Inc. v. Commissioner, 286 F.3d 324 (6th Cir. 2002), rev'g 113 T.C. 169 (1999).

53 To satisfy the active business test, the business would also need to be conducted in Barbados. Given the amount of activity necessary to manage the investments relating to the U.S. group, and the fact that Board meetings will in any event need to be held in Barbados to qualify as a Barbados resident, it may be somewhat more plausible that this requirement could be satisfied.

> (a) it is licensed to accept deposits from residents of the Contracting State of which it is a resident and to conduct, in that State, lending or other banking activities;
>
> (b) it regularly accepts deposits from customers who are residents of the Contracting State of which it is a resident in the ordinary course of its business and the amount of deposits shown on the company's balance sheet is substantial; and
>
> (c) it [regularly makes] loans to customers in the ordinary course of its trade or business[.]"[54]

A Barbados holding company will have its work cut out for it in trying to satisfy these requirements and thereby qualify as a bank under the Pending Protocol. First, it will need to obtain a license to accept deposits from Barbados residents and to conduct lending or other banking activities in Barbados. This may not be an easy task. Moreover, even if such license can be obtained, the holding company will need to "regularly" accept deposits from customers who are residents of Barbados, and accept enough deposits so that the amount of deposits shown on its balance sheet is substantial.[55] The holding company will also need to "regularly" make loans to customers in the ordinary course of its trade or business, although it appears that such customers need not be residents of Barbados or any other specific jurisdiction.

In other words, a holding company seeking to access the Treaty as a Barbados bank will need to obtain a license to conduct, and actually conduct, a real banking business in Barbados. It seems unlikely that many inverted public companies, or their subsidiaries, will consider this a viable method of claiming U.S. treaty benefits.

Partial Denial of Treaty Benefits to Disqualified Residents

Even if a company is otherwise able to satisfy the tougher LOB requirements described above, it will still be denied access to certain provisions of the Treaty if it enjoys the benefits of a "special tax regime".

New Article 22.6(a) of the Treaty will provide in part as follows:

> "(a) Notwithstanding that a person otherwise would qualify for the benefits of the Convention under paragraphs 1 or 2 of this Article without regard to this paragraph, a person that is entitled to income tax benefits under the provisions of a special tax regime shall be entitled to receive

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[54] New Article 22.2(d)(ii) similarly provides that a resident of a Contracting State will be treated as an insurance company only if "(a) it is licensed to insure risks of residents of the Contracting State of which it is a resident; and (b) it regularly insures (not including reinsurance) risks of customers who are residents of the Contracting State of which it is a resident[.]"

[55] Query whether all deposits are taken into account for purposes of the substantiality requirement or only deposits of Barbados residents.

> only the benefits of this Convention (subject to all applicable conditions or limitations) other than the benefits of Articles 10 (Dividends), 11 (Interest) and 12 (Royalties) of this Convention."

Therefore, any person that enjoys the benefits of a "special tax regime" (Disqualified Resident) will not be able to access the dividend, interest, and royalty articles of the Treaty, even if that person otherwise satisfies all of the requirements of the new, tougher LOB article.[56] For this purpose, new Article 22.6(b) will define "special tax regime" as follows:

> "A special tax regime is any legislation or administrative practice that provides for an effective tax rate substantially lower than the generally applicable tax rate for companies or individuals, as appropriate."

To avoid any possible confusion as to which entities are being targeted by the new provision, paragraph 3 of the "Understandings Regarding the Limitations on Benefits Article in the U.S.-Barbados Protocol" expressly provides that, in the case of Barbados, a special tax regime includes "the International Business Companies Act[.]"

When the new LOB provision takes effect, a corporation that is resident in Barbados but pays relatively minimal Barbados tax pursuant to the IBC regime will no longer qualify for the benefits of the dividend, interest and royalty articles, even if it otherwise satisfies the requirements of the LOB article, *e.g.*, the public company test or the ownership/base erosion test. Such a company will be subject to U.S. withholding tax at the 30% statutory rate on U.S.-source dividend, interest and royalty payments (other than effectively connected income).[57] Thus for example, the 30% withholding rate will apply to all such payments by a U.S. corporation to an affiliated IBC. Note that new Article 22.6 will not deny the benefits of Article 13A (Branch Tax). Presumably, no one is concerned that Barbados resident corporations are eager to conduct business through U.S. branches.[58]

New Article 22.6 of the Treaty, which focuses on whether a low tax rate results from a "special tax regime", as opposed to the availability of favorable rates generally, is reminiscent of the "special measures" test that was adopted in a number of older U.S. income tax treaties. Under

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[56] Rather than providing that persons subject to a special tax regime "shall be entitled to receive only the benefits of this Convention … other than the benefits of Articles 10 (Dividends), 11 (Interest) and 12 (Royalties)" it would seem more straightforward to state directly that such persons are not entitled to the benefits of the dividend, interest and royalty articles. The reason for the obfuscation is not apparent.

[57] In the case of interest, this assumes that the interest does not qualify as portfolio interest. As noted above, interest paid to a "10-percent shareholder" cannot qualify as portfolio interest, and attribution rules apply for purposes of determining 10-percent shareholder status. §§871(h)(3) and 881(c)(3)(B).

[58] Note, for example, that the rules for determining the amount of interest expense allocable to a U.S. branch, or permanent establishment, are unfavorable. Reg. §1.882-5 generally allocates a foreign corporation's interest expense in accordance with the portion of the corporation's assets located within and without the United States, regardless of where the borrowed funds are actually deployed. But see National Westminster Bank, PLC v. United States, 44 Fed. Cl. 120 (1999), which held the predecessor regulations to be invalid as applied to a U.K. bank entitled to the benefits of Article 7 (Business Profits) of the United States-United Kingdom Income Tax Treaty, signed December 31, 1975. For an in-depth discussion of Natwest, see Katz, "Regs. §1.882-5 and Article 7: Moving in a NatWesterly Direction," 28 Tax Mgmt. Int'l J. 611 (Oct. 1999).

the most common version of the special measures test, certain treaty benefits are denied to a corporation if (1) "by reason of special measures" the tax rate on specified items of income is less then the generally applicable rate and (2) a specified percentage of the capital of the corporation is directly or indirectly owned by persons who are not individual residents for treaty purposes of the same Contracting State as the corporation (or U.S. citizens).

For example, Article 27 (Investment or Holding Companies) of the current U.S.-Iceland Income Tax Treaty, signed May 7, 1975, provides as follows:

> "A corporation of one of the Contracting States deriving dividends, interest, royalties, or capital gains from sources within the other Contracting State shall not be entitled to the benefits of Articles 12 (Dividends), 13 (Interest), 14 (Royalties), or 16 (Capital Gains) if:
>
> (a) By reason of special measures the tax imposed on such corporation by the first-mentioned Contracting State with respect to such dividends, interest, royalties, or capital gains is substantially less than the tax generally imposed by such Contracting State on corporate profits, and
>
> (b) 25 percent or more of the capital of such corporation is held of record or is otherwise determined, after consultation between the competent authorities of the Contracting States, to be owned directly or indirectly, by one or more persons who are not individual residents of the first-mentioned Contracting State (or, in the case of an Icelandic corporation, who are citizens of the United States)."

The U.S. income tax treaties with Egypt, Korea, Morocco, Norway and Trinidad and Tobago contain comparable provisions.[59]

A similar limitation appeared in Article XV of the former U.S.-Luxembourg Income Tax Treaty, signed December 18, 1962, although that provision did not use the term "special measures" and contained no ownership requirement. That article provided in part as follows:

> "The present Convention shall not apply to the income of any holding company entitled to any special tax benefit under Luxembourg Law of July 31, 1929 … or to any income derived from such corporation by any shareholder thereof."

Moreover, new Article 22.6(a) of the Treaty is consistent with the principal objective of tax treaties: avoidance of double taxation. As noted by Treasury Secretary John W. Snow at the Signing Ceremony for the Pending Protocol: "A tax treaty is intended to mesh the tax systems of the two countries so that there is little potential for dispute regarding the amount of tax that

[59] U.S.-Egypt Income Tax Treaty, signed August 24, 1980, Art. 24; U.S.-Korea Income Tax Treaty, signed June 4, 1976, Art. 17; U.S.-Morocco Income Tax Treaty, signed August 1, 1977, Art. 24; U.S.-Norway Income Tax Treaty, signed December 3, 1971, Art. 20; U.S.-Trinidad and Tobago Income Tax Treaty, signed January 1, 1970, Art. 16.

should be paid to each country and so that there is little potential for the double taxation that can arise when the two governments both claim taxing jurisdiction over the same income." Based upon the favorable Barbados tax rules for IBCs, it appears that there is currently very little prospect for double taxation that would justify treaty relief.[60]

The new rule in the Treaty for special tax regimes is very much a "belt and suspenders" provision. As discussed above, inverted public companies will still face formidable obstacles in trying to satisfy even the basic requirements for Treaty access under the new LOB article.

Conclusion: Implications for the Future

The Pending Protocol's new LOB article is uncommonly strict in several respects. As noted above, the new LOB article differs from most U.S. tax treaties in that the public company test cannot be fully satisfied through trading in the other Contracting State, in that the public company subsidiary test imposes a base erosion requirement, and in that the ownership prong of the ownership/base erosion test requires "same country" ownership. Moreover, the base erosion provision is unprecedented in that it treats payments to residents of the other Contracting State as base eroding payments, thus making it extremely difficult to satisfy either the ownership/base erosion test or the public company subsidiary test. No other U.S. income tax treaty contains such a harsh base erosion provision.

Clearly, the U.S. negotiators were motivated by the overriding objective of preventing inverted public companies with no meaningful nexus to Barbados from claiming the benefits of the Treaty. Therefore, it is tempting to dismiss the harsher aspects of the Pending Protocol as unique to the situation with Barbados. At least some of those provisions, however, may also reflect an evolution in U.S. tax treaty policy. For example, the Pending Protocol, along with the protocol to the Dutch treaty signed earlier this year, may signal an increasing reexamination of the long-held assumption that public companies do not engage in treaty shopping. It remains to be seen whether any elements of the Pending Protocol will influence future LOB provisions.

[60] JS-1786. See also the legislative history to §1(h)(11), which prescribes a 15% maximum tax rate for qualified dividend income received from domestic corporations and qualified foreign corporations, including certain foreign corporations eligible for the benefits of a satisfactory U.S. income tax treaty. H.R. Rep. 108-126, 108th Cong., 1st Sess. at 42 (2003) ("The conferees do not believe that the current income tax treaty between the United States and Barbados is satisfactory for this purpose because that treaty may operate to provide benefits that are intended for the purpose of mitigating or eliminating double taxation to corporations that are not at risk of double taxation."). Presumably, the Treaty will be considered more than satisfactory once the new LOB article takes effect.